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No. 95-1284

In the Supreme Court of the United States

OCTOBER TERM, 1995

NORWEST CORPORATION AND AFFILIATED COMPANIES, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether Section 4.901-2(f)(3)(ii) of the Temporary Treasury Regulations, 26 C.F.R. 4.901-2(f)(3)(ii), is valid.

2. If Section 4.901-2(f)(3)(ii) is valid, whether the amount of Brazilian taxes nominally withheld from interest paid to petitioner by Brazilian borrowers, but then rebated by Brazil to those borrowers, is an indirect subsidy within the meaning of the regulation and thus does not constitute a tax "paid or accrued" to Brazil for which a foreign tax credit is available under Section 901 of the Internal Revenue Code, 26 U.S.C. 901.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-11a) is reported at 69 F.3d 1404. The opinion of the Tax Court (Pet. App. 12a-25a) is reported at 63 T.C.M. (CCH) 3023.

JURISDICTION

The judgment of the court of appeals was entered on November 14, 1995. The petition for a writ of certiorari was filed on February 12, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTE AND REGULATION INVOLVED

The relevant portions of Section 901 of the Internal Revenue Code, 26 U.S.C. 901, and of Section 4.901-2 of the Temporary Treasury Regulations, 26 C.F.R. 4.901-2 (1981), are set forth at Pet. App. 31a-34a.

STATEMENT

1. During the years in issue, Norwest Corporation and various affiliated lenders (collectively referred to as "petitioners") made loans to borrowers located in Brazil (Pet. App. 2a, 13a). The loans were made on a net quoted basis—that is, the borrowers (i) agreed to pay petitioners a specified interest rate on the loan and, in addition, (ii) agreed to pay directly to Brazil, on behalf of petitioners, any taxes imposed by Brazil on such interest payments (*id.* at 12a, 20a).

Since 1943, the Brazilian federal government has imposed a tax, which is withheld at the source, on interest remitted to foreign lenders. During the years in issue, the nominal rate of the tax was 25 percent (Pet. App. 20a). Brazilian law required a "gross-up" in calculating the amount of this tax imposed on the interest paid on net loans. If, for example, the rate of interest on a net loan were 12 percent, the tax would be computed as though the interest rate were 16 percent, so that 4 percent (*i.e.*, 25 percent of the "gross" rate of interest) would be "withheld" when the 12-percent net interest was remitted to the foreign lender (*id.* at 21a n.4).

Some of petitioners' loans were made to Brazilian banks that, in turn, made "repass" loans under Resolution 63 of the Brazilian Central Bank. That Resolution permitted certain Brazilian banks to borrow funds from abroad for the purpose of relending those funds to smaller Brazilian borrowers who

lacked access to international financial markets. The terms of Resolution 63 loans (as well as other loans to Brazilian borrowers from foreign lenders) were subject to regulation by the Brazilian government. The borrowing banks could relend, or "repass," the borrowed funds to domestic companies (repass borrowers) for shorter terms and smaller amounts than the direct foreign borrowings. There was no direct legal relationship between the foreign lender and the repass borrower in a Resolution 63 transaction, for the loan agreement between the foreign lender and the borrowing bank was independent of the loan agreement between the borrowing bank and the repass borrower. The borrowing bank, and not the repass borrower, was responsible for paying the interest to the foreign lender and for paying the taxes imposed by Brazil on that interest. The terms of repass loans, however, required each repass borrower to pay (i) an amount equal to its pro-rata share of the costs (interest *plus* tax) of the direct foreign borrowing from which the repass loan was made and (ii) a repass commission to the Brazilian bank (Pet. App. 3a, 17a-18a).

In August, 1975, Brazil instituted the "pecuniary benefit" program. Under this program, Brazilian borrowers that paid interest to foreign lenders would receive a "pecuniary benefit," or subsidy, that reduced by 85 percent the amount of the tax to be paid on the interest due on the loan (Pet. App. 15a-16a). [1] In Resolution 63 transactions, the borrowing bank was

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[1] The amount of the pecuniary benefit was reduced to 50 percent of the tax in July, 1979, increased to 95 percent of the tax in December, 1979, reduced to 40 percent of the tax in May, 1980, and reduced to zero in July, 1985 (Pet. App. 16a).

required immediately to pass the cost reduction resulting from the "pecuniary benefit" on to its repass borrowers (*id.* at 18a, 25a). The amount of the "pecuniary benefit" was credited to the repass borrower's account on the same day that the remaining portion of the tax was withheld and paid to Brazil (*id.* at 16a).

In determining their United States income tax liability for the years in issue, petitioners took the position that they were entitled to foreign tax credits for the entire amount of the Brazilian taxes incurred with respect to interest payments, including the amounts that Brazil returned to borrowers as a "pecuniary benefit." The amount of the credits claimed by petitioners was $396,317 for 1980 and $524,161 for 1982 (Pet. App. 3a, 13a, 21a, 26a-27a). The Commissioner disallowed petitioners' claims for foreign tax credits with respect to the amounts that Brazil rebated to Brazilian borrowers; the Commissioner also correspondingly decreased the amount by which petitioners had "grossed-up" their interest income (*id.* at 21a).

2. Petitioners sought Tax Court review of the Commissioner's determinations. The Tax Court agreed with the Commissioner, however, that petitioners were not entitled to a foreign tax credit for the amounts that Brazil rebated to Brazilian borrowers as a "pecuniary benefit." The court explained that the rebated amounts—which were collected by Brazil from, and then returned by Brazil to, Brazilian borrowers—did not, in substance, represent taxes that petitioners paid to Brazil (Pet. App. 22a-25a). The court also concluded (*id.* at 24a-25a) that this rebate of the tax to the Brazilian borrowers who had remitted it in the first place represented an indirect

subsidy to the business being conducted by petitioners and therefore did not qualify as a tax paid to Brazil under the applicable Treasury regulation (26 C.F.R. 4.901-2(f)).

3 The court of appeals affirmed on the second of the Tax Court's two rationales (Pet. App. 1a-11a). The court relied on the regulation that was in effect during the years in issue and on the Seventh Circuit's decision in *Continental Illinois Corp* v. *Commissioner*, 998 F.2d 513, 518-519 (7th Cir. 1993), cert. denied, 114 S. Ct. 685 (1994), which relied upon the same regulation in deciding the identical issue. Under that regulation, an amount is not to be treated as a tax paid or accrued to a foreign country (and is therefore not eligible for the foreign tax credit) if the proceeds of the tax are used, directly or indirectly, to provide a subsidy to the business conducted by the taxpayer. 26 C.F.R. 4.901-2(f)(3)(ii). The court of appeals upheld this regulation as a reasonable interpretation of the pertinent statutory language. The court further concluded that the amounts rebated to Brazilian borrowers represented indirect subsidies to petitioners within the meaning of the regulation (Pet. App. 5a-11a). Having concluded that this case is controlled by the regulation, the court expressly declined to consider whether the amounts that Brazil received from—and then rebated to—Brazilian borrowers were not, in substance, a tax paid to Brazil (*id.* at 11a n.6).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Indeed, the decision in this case follows the same analysis and reaches the

same conclusion as the only other appellate decision directly on point (*Continental Illinois Corp.* v. *Commissioner*, 998 F.2d 513, 518-519 (7th Cir. 1993), cert. denied, 114 S. Ct. 685 (1994)). Moreover, for all years after 1986, Congress has authoritatively resolved the questions presented in this case by enacting Section 901(i) of the Internal Revenue Code, which codifies the position taken by the Commissioner. See 26 U.S.C. 901(i). Further review of the decision of the court of appeals is therefore not warranted.

1. a. Section 901 of the Internal Revenue Code allows taxpayers a credit against their federal income tax liability for "the amount of any income * * * taxes paid or accrued during the taxable year to any foreign country." 26 U.S.C. 901(b)(1). Section 4.901-2(f) of the Temporary Treasury Regulations interprets the language "paid or accrued" in Section 901 of the Code. Under that regulation, an amount of tax that the foreign country is expected to refund is not deemed a tax paid or accrued (26 C.F.R. 4.901-2(f)(2)). The regulation further provides that an amount of tax that the foreign country uses to provide a subsidy (determined by reference to the amount of the tax) to the taxpayer is not deemed a tax paid or accrued (26 C.F.R. 4.901-2(f)(3)(i)).

Brazil did not provide a direct subsidy to petitioners that comes within this provision. But the regulation also addresses the rebate of foreign taxes as indirect subsidies (26 C.F.R. 4.901-2(f)(3)(ii)):

> A foreign country is considered to provide a subsidy to a person if the country provides a subsidy to another person that—
>
> * * * * *

> (B) Engages in a business transaction with the first person, but only if the subsidy received by such other person is determined directly or indirectly by reference to the amount of income tax * * * imposed by the country on the first person with respect to such transaction.

The court of appeals concluded in this case that the rebate by Brazil of taxes collected from Brazilian borrowers, and then automatically returned to them, represented an indirect subsidy within the scope of this regulation (Pet. App. 7a-11a).

b. Petitioners contend (Pet. 14-18) that the interpretation of this regulation by the Eighth Circuit in the present case and by the Seventh Circuit in *Continental Illinois* is inconsistent with the foreign tax credit provisions of Section 901 of the Code.

Treasury regulations are to be upheld "if they implement the congressional mandate in some reasonable manner." *Rowan Cos.* v. *United States*, 452 U.S. 247, 252 (1981) (internal quotation marks and citation omitted). As this Court has explained, "if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 (1984). Deference is afforded to the Commissioner's interpretations of the tax statutes because (*National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 477 (1979)):

> "Congress has delegated to the * * * Commissioner [of Internal Revenue], not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal

> Revenue Code. 26 U.S.C. § 7805(a)." *United States* v. *Correll*, 389 U.S. [299,] 307 [(1967)]. That delegation helps ensure that in "this area of limitless factual variations," *ibid.*, like cases will be treated alike. It also helps guarantee that the rules will be written by "masters of the subject," *United States* v. *Moore*, 95 U.S. 760, 763 (1878), who will be responsible for putting the rules into effect.

Petitioners do not challenge the provisions in the regulation (26 C.F.R. 4.901-2(f)(2) and (3)(i)) that provide that a tax has not been paid or accrued to a foreign country to the extent that it is to be refunded to the United States taxpayer or is to be returned as a direct subsidy to the business of the United States taxpayer. Nor would those provisions reasonably be subject to challenge. As the courts of appeals have consistently concluded, if amounts paid to a foreign country are similarly used to subsidize the business activities of a United States taxpayer *in*directly, such amounts would no more constitute taxes paid or accrued to a foreign country than would amounts returned to the taxpayer directly. See Pet. App. 9a-10a; *Continental Illinois Corp.* v. *Commissioner*, 998 F.2d at 520.

As the court of appeals explained in this case, it is often difficult, if not impossible, to identify the "actual" recipient of the economic benefits of a governmental subsidy (Pet. App. 8a-9a & n.4, quoting *Con-tinental Illinois Corp.* v. *Commissioner*, 998 F.2d at 519-520). The court noted that the indirect subsidy provision of Temp. Treas. Reg. § 4.901-2(f)(3)(ii) serves the reasonable function of providing an administrable, bright-line test for determining whe-

ther a subsidy has been indirectly provided to the taxpayer (Pet. App. 8a-9a & n.4). The court explained that the regulation accomplishes that end by "defin[ing] cer-tain amounts of tax as subsidies without reference to actual economic benefit" (*id.* at 9a).

As the court concluded, the administrable rule provided by the regulation is a reasonable interpretation of the general provisions of the statute (Pet. App. 8a). Recognizing that the underlying statutory provisions cannot reasonably be understood to authorize a tax credit for taxes that are rebated to the benefit of the taxpayer, the court of appeals (*ibid.*) agreed with the Seventh Circuit in *Continental Illinois*, 998 F.2d at 520, that "[t]he regulation is clear as a bell, and its validity [on this point] cannot be seriously questioned" (Pet. App. 9a).

c. The court of appeals was correct in concluding that the provisions of Temp. Treas. Reg. § 4.901-2(f)(3)(ii) apply to and are controlling in this case. As the Seventh Circuit also correctly stated with respect to identical facts in *Continental Illinois*, 998 F.2d at 520, the regulation "fits this case to a t." The Brazilian "pecuniary benefit"—which effects a rebate of the tax to the Brazilian borrowers who funded and remitted it—represents an indirect subsidy to petitioners within the meaning of Temp. Treas. Reg. § 4.901-2(f)(3)(ii): the rebate is provided to a person (a Brazilian borrower) that engages in a business transaction with petitioners, and the amount of the pecuniary benefit is calculated as a specific percentage of the amount of the tax imposed on the payment to petitioners. The court of appeals thus correctly held (Pet. App. 8a-10a) that, under the regulation, (i) the pecuniary benefit constitutes a subsidy to the

business that petitioners conduct and (ii) the amount returned (or "rebated") by Brazil to the Brazilian borrowers (who paid the tax on petitioner's behalf) is therefore not a creditable tax "paid or accrued" by petitioner for purposes of Section 901 of the Code.

This application of Temp. Treas. Reg. § 4.901-2(f)(3)(ii) is particularly appropriate with respect to the "net" loans involved in this case. Petitioners were paid interest by its Brazilian borrowers at a "net" rate, without subtraction of the Brazilian tax which the borrowers, rather than petitioners, remitted directly to Brazil. Brazil then returned a portion of those tax payments to the borrowers who had remitted them. It would obviously be unrealistic to contend that petitioners—who never remitted any of these funds to Brazil—should be deemed to have "paid" a tax that was returned to those who remitted it. There quite obviously was no "double tax," as petitioners mistakenly contend (Pet. 9): indeed, to the extent that the Brazilian borrowers received *their* payments back from Brazil, it cannot realistically be claimed that anyone "paid" a tax to Brazil, whether on their own or on petitioners' behalf.

2. Petitioners assert (Pet. 15-18) that a subsidy granted by a foreign taxing authority should reduce a United States taxpayer's foreign tax credit only to the extent that the United States taxpayer receives some traceable benefit from the subsidy (Pet. 15).[2]

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[2] Petitioners similarly contend that the court of appeals erred in holding that the indirect subsidy rule of Temp. Treas. Reg. § 4.901-2(f)(3)(ii) applies in the case of Resolution 63, or "repass," loans, on the theory that the repass borrowers were not engaged in any business transactions with petitioners (Pet. 20-21). That contention has been rejected by every court that has addressed it. See Pet. App. 11a; *Continental Illinois*, 998

As the court of appeals noted, however, one purpose of the regulation is to provide an administrable rule that "defines certain amounts of tax as subsidies without reference to actual economic benefit" (Pet. App. 9a). Moreover, petitioners' contention that they did not receive an economic benefit from the Brazilian subsidy lacks both evidentiary and logical support. It is obvious that the ability of petitioners to do business in Brazil was directly assisted by Brazil's determination to reduce the tax burdens associated with petitioners' lendings, by providing a "pecuniary benefit" in the form of a rebate of the taxes that were collected from Brazilian borrowers in connection with such transactions.

In claiming that the Brazilian subsidy conferred no benefit on its activities in Brazil, petitioners rely heavily on an early ruling of the Commissioner that allowed a foreign tax credit for the Brazilian tax (Pet. 15-16). It is quite clear, however, that petitioners are not entitled to rely on private letter rulings respecting the Brazilian pecuniary benefit that were not issued to petitioners. See 26 U.S.C. 6110(j)(3). In any event, petitioners can gain no support from the fact that the Commissioner has reviewed this issue more recently and has revised her position to take account of the information now fully available to her. This Court has often noted that the Commissioner is not

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F.2d at 520 (Resolution 63 loans "fell within the letter as well as the spirit of the subsidy regulation"). Petitioners' suggestion that there is no business connection between petitioners' Resolution 63 loans and the activities of "repass" borrowers is logically flawed, for the stated purpose of Resolution 63 loans was to obtain funding for repass borrowers who otherwise would not be able to borrow directly in international financial markets. See page 2-3, *supra*.

required to adhere to discarded, prior rulings but may revise them as she finds necessary and appropriate in the circumstances. See, *e.g.*, *Dickman* v. *Commissioner*, 465 U.S. 330, 343 (1984); *Dixon* v. *United States*, 381 U.S. 68 (1965). The question ad-dressed in this case is whether the Commissioner's current position is correct. The Seventh and Eighth Circuits have correctly held that it is, and no other circuit has held to the contrary.[3]

3. a. Petitioners contend (Pet. 10-12) that the decision of the court of appeals conflicts with the decisions of the Court of Claims in the Mexican railroad car cases.[4] The Mexican railroad car cases

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[3] In 1986, Congress added 901(i) to the Internal Revenue Code, Tax Reform Act of 1986, Pub. L. No. 99-514, § 1204(a), 100 Stat. 2532, to "clarify and codify" the position that the Commissioner has taken in this case on the subsidy issue S. Rep. No. 313, 99th Cong., 2d Sess. 325 (1986)). Contrary to petitioner's assertion (Pet. 16 n.2, 20 n.3), the enactment of Section 901(i) and the promulgation of regulations under that statute in 1988 do not reflect that the Commissioner's position was incorrect for years before the enactment of that statute and the adoption of implementing regulations. Although the new provision was made prospective in operation, Congress, as petitioner admits (Pet. 16 n.2), explicitly manifested its intention that no inference be drawn from its action as to the validity or invalidity of the regulation in effect before the enactment of the statute. H.R. Rep. No. 426, 99th Cong., 1st Sess. 352 (1986).

[4] *Missouri Pac. R.R.* v. *United States*, 497 F.2d 1386 (Ct. Cl. 1974); *Chicago, B. & Q. R.R.* v. *United States*, 455 F.2d 993 (Ct. Cl. 1972), rev'd on other grounds, 412 U.S. 401 (1973); *Missouri-Illinois R.R.* v. *United States*, 381 F.2d 1001 (Ct. Cl. 1967). See also *Missouri Pac. R.R.* v. *United States*, 301 F. Supp. 839 (E.D. Mo. 1967), aff'd in part and rev'd in part on other grounds, 411 F.2d 327 (8th Cir. 1969), cert. denied, 396 U.S. 1037 (1970).

addressed whether a 10 percent tax withheld from the per diem rentals owed by Mexican railroads for the use of railroad cars owned by United States companies was eligible for the foreign tax credit under Section 901 of the Code. The Internal Revenue Service took the position that this 10 percent charge did not, in substance, represent a tax paid to Mexico because the withholdings were not paid to the Mexican government but were instead retained by the Mexican railroads, as a subsidy for their operations. The Court of Claims, however, rejected the government's contention (*Missouri Pac. R.R.* v. *United States*, 497 F.2d 1386, 1395 (Ct. Cl. 1974)):

> That Mexico elected to appropriate the proceeds of the levies to the benefit of its domestic rail carriers does not mean that the sums involved were not collected from the plaintiff as a tax.

In the present case, the Tax Court (Pet. App. 22a) followed its earlier decision in *Nissho Iwai American Corp.* v. *Commissioner*, 89 T.C. 765, 777 (1987), in which it expressly declined to follow the Mexican railroad car cases. The Tax Court held that to treat the payment of the Brazilian tax as one completed transaction, and payment of the subsidy as a wholly separate event, would be to "ignore the true unity of the transaction and elevate form over substance" (Pet. App. 22a).

Even if, for purposes of argument, it were assumed that a decision as to the United States tax consequences of a tax imposed under Mexican law could be said to conflict with a ruling as to the United States tax effects of a wholly different tax imposed under the law of Brazil, this case could arguably be said to be in conflict with the Mexican railroad car

cases *only* if the court of appeals had adopted the substance-over-form analysis that the Tax Court applied in this case. But the court of appeals did *not* decide this case on that basis. Instead, the court explicitly stated that it would not consider the application of the "substance over form" doctrine in this case (Pet. App. 11a n.6). [5]

As we have discussed, the court of appeals expressly based its holding that petitioners are not entitled to a foreign tax credit with respect to foreign taxes that were rebated to Brazilian borrowers on the provisions of Temp. Treas. Reg. § 4.901-2(f)(3) (Pet. App. 5a-11a). Because that regulation did not exist at the time the Mexican railroad car cases arose and were decided, the decision in this case could not possibly be said to conflict with the decision of the Court of Claims in those cases. [6] Moreover, in concluding that the regulation is valid and that, under its provisions, the rebates Brazil provided to Brazilian borrowers represent indirect subsidies to petitioners, the Eighth Circuit endorsed and followed the reasoning of the Seventh Circuit in *Continental Illinois*, 998 F.2d at 519-520 (Pet. App. 8a-10a). The only two courts of appeals that have considered the questions presented in this case have thus agreed as to the

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[5] While determining that the taxpayer in *Continental Illinois* was not entitled under Temp. Treas. Reg. § 4.901-2(f)(3) to a foreign tax credit with respect to foreign taxes that were rebated to its Brazilian borrowers, the Seventh Circuit rejected as "unsound" the position of the Commissioner and the Tax Court that the foreign tax credit should be denied on "substance over form" grounds (998 F.2d at 519).

[6] Temp. Treas. Reg. § 4.901-2 was adopted in November, 1980. T.D. 7739, 1981-1 C.B. 396, 409.

validity and application of Temp. Treas. Reg. § 4.901-2 (f)(3) to the facts presented here.

b. Petitioners err in contending that the decision in this case is "at odds with" (Pet. 13) this Court's ruling in *Hillsboro National Bank* v. *Commissioner*, 460 U.S. 370 (1983). The *Hillsboro* case has nothing to do with the issues presented here.

In *Hillsboro*, the Court held that, when a bank has paid on behalf of its shareholders a state property tax imposed on the ownership of bank shares, and has received a deduction for that payment under Section 164(e) of the Code, the tax benefit rule does not require the bank thereafter to recognize income when the State, in a separate transaction, refunds the tax to the shareholders. Section 164(e) provides that, when a corporation pays such a tax on behalf of its shareholders, the corporation—and not the shareholder—is entitled to the deduction for the payment of the tax. 26 U.S.C. 164(e)(1) and (2). The Court concluded that, so long as the corporation does not itself receive a refund of the payments for which it claimed a deduction, the refund to the shareholders (which would represent taxable income to them) did not require the corporation itself to recognize income. 460 U.S. at 394-395.

The question addressed in *Hillsboro* did not involve whether the corporation obtained a direct or indirect benefit from the refund to its shareholders of the tax it had paid. By contrast, the right of a taxpayer to a credit under Section 901 for foreign taxes paid or accrued turns precisely upon the question—addressed in the regulation—whether a tax has been "paid or accrued" when it is applied, directly or indirectly, to subsidize the taxpayer's business activities. The issue addressed in *Hillsboro* has no logical

relationship to the question presented and resolved by the court of appeals in this case.

4. As previously discussed (note 3, *supra*), and as petitioners concede (Pet. 16 n.2), Congress has prospectively resolved the question of statutory interpretation addressed in this case by amendments to Section 901 that were enacted in 1986. Petitioners acknowledge that the revised statute "codif[ies] the Commissioner's position on the subsidy issue" (Pet. 16 n.2). See 26 U.S.C. 901(i); note 2, *supra*. Because there is no conflict among the courts of appeals as to the proper application of the statute for years before 1986, and also because the underlying statutory question has been authoritatively resolved by Congress for years after 1986, further review by this Court is not warranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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